CONSTRUCTION AND DEVELOPMENT LOAN REQUEST. A CASE STUDY

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Abstract. *With malls and shopping centers a dominant venue of merchandising, the case deals with a company seeking to finance the construction and development of a strip shopping center in Romania. With this kind of financing a demanding type of commercial real estate credit, the case aims to highlight the structure and pricing of construction and development lending, the requisite financial information and the critical role of other aspects of the project. The credit decision process calls for evaluating the merits of the loan request and assessing the bank's risk exposure.*

Keywords: debt service coverage ratio, London Interbank Offered Rate or LIBOR, private equity investment firm, real estate investment and property development, retail park, underwriting standards.

1. Introduction

Hellenic National Bank is a Boston-based institution with interstate operations through a network of 35 branches in select metropolitan centers in the East Coast. Its international department offers the customary international services, such as deposits and loans, transfer of funds, foreign exchange, and foreign trade financing. The bank maintains correspondent banking relationships with several foreign institutions and has two branches abroad, in London and Frankfurt. Recently the bank established a representative office in Bucharest, Romania, in recognition of the growth prospects of Eastern Europe.

George Hart, a loan officer at Hellenic Bank, has been assigned the loan request of Garda Investment Associates, Ltd., a private equity investment firm, seeking to finance the development (e.g., such site improvements as roadways, installation of public utilities, and landscaping) and construction of a strip shopping center in Romania on land it currently owns free and clear. The shopping center will consist of a 33,211 square feet (sf) of net leasable area and will comprise a 27,691 sf retail center and a 5,520 sf outparcel restaurant building. Exhibit 1 identifies potential tenants (based on letters of intent) and rates for 86 percent of the rentable property (3 bays comprising 4,642 sf remain uncommitted). The real estate agent estimates that the vacant bays will be leased within the next 9 months. Exhibit 2 provides a pro forma income and expense analysis for the first two years of operation, and Exhibit 3 highlights two of the project's key financial indicators.

Construction and development of the shopping center is expected to take 15 months to complete at a cost of $3,800,000. The client was informed of the bank's practice to price such credits on the basis of the London Interbank Offered Rate or LIBOR, by calculating construction interest based upon the average loan balance during the construction phase (e.g., 60%). The rate charged is one-month LIBOR (currently at 0.25 percentage points) plus a spread of 3.50 percentage points, with the floor rate (lowest rate to be charged) set at 4.50 percentage points. Based upon the floor rate, the construction loan would result in interest charges of $128,250, which would raise the loan amount to $3,928,250. Once the shopping center is built the construction loan would convert into a term loan (also known as mini permanent financing, or mini perm). Monthly payments against the mini perm may run at $27,141 based upon a 25 year amortization and a 6.75 percent fixed rate, with a balloon payment due in 5 years.

2. Borrower's Background

Garda Investment Associates Ltd., (Garda) is a Luxembourg-registered private equity firm engaged in real estate investment and property development in Romania. The company was established by Sorin Nelersa with a 40 percent limited partnership interest, and Claudiu Nelersa, A. Nicholson, and M. Corhana each owning 20 percent interest in the firm. The principal is a seasoned professional with twenty years of real estate development and management experience, and a long standing relationship with the Miami office of the Hellenic Bank.

Born and raised in Galati, Romania, Sorin Nelersa moved to South Florida in the late 1980s. While studying for a business degree in a local university he pursued an employment opportunity with a real estate development firm which he joined full time upon his graduation. As his employer was actively engaged in commercial real estate development, Sorin became exposed over time to a number of projects and especially shopping centers in various Central and West Florida markets. For example, he participated in, or helped coordinate, the development of shopping centers in such cities as Orlando, Fort Myers, Pensacola, Sarasota and Tampa. Some of these were strip centers, others were neighborhood or community centers and in one instance a major mall (for a distinction among these types of facilities see Exhibit 4). Whatever the project, he enjoyed the challenge associated with it, and his hard work earned him successive promotions that led, within a twenty-year span and two employers later, to a senior position in a major condominium development company in Miami. Just as Sorin's professional career seemed to rise precipitously, it suddenly came to a halt.

3. Financial Crisis

The financial crisis that was triggered by subprime debt in the summer of 2007 had important implications not just for Sorin's employer but for the real estate sector, the banking industry and the U.S. economy as a whole. The bursting of the housing market bubble precipitated a drastic drop in housing prices, which led to borrower defaults and eventual foreclosures, with resulting losses for banks. Commercial real estate came next, with many retailers retrenching during the recession through store closures or the renegotiation of leases with landlords--actions that eroded the income of the retailers and consequently the investors' debt servicing ability. These conditions worsened during 2009. The onset of 2010 ushered some positive economic news. Unemployment seemed to stabilize and even improve, and consumers began to spend, returning to malls in droves. Rock-bottom interest rates allowed strapped developers and real estate owners to refinance on favorable terms. Despite some big write-downs of commercial real estate loans, most borrowers appeared to have had the cash flow to keep loan payments current or refinance to buy more time. Although some questions remain as to whether the economy had gone through the bottom of the cycle, the stability or rise of rents in several markets is viewed by some as a considerable improvement from the immediately preceding period. Given the reporting lag, it is felt that the bottom may have been already reached.

As the crisis was unfolding in the United States and spreading to other developed economies, Sorin started exploring the prospects of getting back in business on his own. A short visit to his country of birth in 2009 made him aware of opportunities for shopping centers in Romania. The country had emerged from communism in 1989 with the overthrow of the communist regime. Although this development marked the beginning of a new era for Romania, it also presented a formidable challenge for the post revolution government. There was an immediate need to enact sound macroeconomic policies and transform an obsolete industrial base into an efficient market economy. A decade later, the reforms implemented (bolstered by funding from the World Bank) had produced positive results--they had transformed the Romanian economy into one characterized by relative economic stability, low unemployment and a high rate of growth. The most notable accomplishment, however, was the country's admission into the European Union (January 1, 2007), with accession to the Eurozone projected for 2012 (or by as late as 2014, according to some sources).

The global financial crisis of 2007-2009 caused Romania to suffer a reversal of fortune. The years of record economic growth, fueled by easy credit and heavy foreign investment, gave way to a sharp slowdown that threatened an economic collapse. An emergency funding in the amount of $27 billion helped cushion the effects of the severe drop in private-capital inflows by facilitating implementation of policy measures that addressed external and fiscal imbalances and strengthened the financial sector. This funding consisted of a two-year standby loan of $17.6 billion from the International Monetary Fund and $9.5 billion from the European Union, the World Bank and the European Bank for Reconstruction and Development. These moves eased financing pressures and supported a drive for fiscal stability, which has been deemed essential for resumption of economic development and needed structural reforms to place the country back on the road to convergerence with other EU member countries.

Sorin's aspirations were not deterred by the state of the Romanian economy. The global economic crisis had curbed Romanian exports, caused a marked slowdown in economic activity (GDP), and doubled the level of unemployment. Published data indicated a fall in the cost of labor by 20 percent and a drop in real estate values to 2005-2006 levels. These developments, Sorin felt, played out to his benefit as they reduced the cost of the required investment. And if the investment financing was to be sourced abroad, additional cost savings were expected to result from the depreciated value of the Romanian currency (New Lei or RON) brought about by investors' flight to stronger currencies (e.g., dollars, euros, and yen). He recognized that businesses that are willing to embrace considerable risk when the economy seems to be collapsing are amply rewarded afterwards when conditions improve and recovery sets in. Essentially, he felt, it was a risk/return trade off.

4. Investing in Romania: Project Site

It was under these circumstances that Sorin moved to establish Garda. His next move was to narrow down the location for his shopping center among alternate sites. A study he had come across indicated that with malls having opened up in Romania's largest cities, investor focus was bound to shift next to smaller cities (e.g., with populations between 50,000 and 200,000) which lacked a shopping center. Another prospect would be the opening of a retail park (also known as a power center) featuring, besides a mall or commercial gallery, a do-it-yourself (DIY) store, a furniture store and a cash and carry superstore. This kind of facility is customarily built on the fringe of a large town, or city, because of cheaper more affordable land and loose planning controls that render development very easy. A retail park often takes away trade from busy city center retailers because of an abundance of free parking and access/proximity to major roads.

After careful site analysis, Sorin became convinced that Brasov, a city in central Romania, offered a good prospect for a shopping center. Although the city already had a small number of shopping centers, the manufacturing base of the local economy and the growth prospects of the region supported the development of additional shopping centers. A city of 280,000 people, Brasov has been the capital of the region with several towns in close proximity, totaling a population of 600,000. Brasov attracted on average another 600,000 people annually who spent at least one night in local hotels. Sorin spared no time in negotiating for Garda the purchase of a one-hectare piece of property for the (crisis) price of 400,000 euros. The property is adjacent to the Coresi Urban Regeneration project www.coresibrasov.ro. This project--managed by Centerra Capital Partners www.centerrapartners.com--aspires to develop a new modern urban center for Brasov encompassing all the vital city functions: retail, offices, residential, leisure, educational and civic spaces combined in harmonious synergy. The Coresi project is close enough to the old city to be convenient yet far enough away to not detract from its charm.

5. Input from Other Professional Firms

Sorin's next move was to contract with a group of professional firms to address requirements at various facets of the project, and secure the appropriate authorizations from public authorities, as needed. An architectural firm was engaged to ensure compliance to building codes, zoning, environmental protection and other government regulations; an engineering firm for mechanical/electrical and civil engineering requirements; a building contractor to construct the shopping center with the proviso that he supplies a completion or performance bond written by an insurance company; and a real estate agent who secured letters of intent from the anchor firm and small retail tenants. Sorin also contracted a property management firm to manage the shopping center for a fee of 4 percentage points of effective gross income.

Although Hellenic Bank has quoted its terms for permanent financing, Sorin has chosen to also inquire with an alternate source of such financing in Europe. A German pension fund has indicated that it would extend this kind of financing in the form of a 15-year mortgage upon submission of a certificate of occupancy at completion of the project.

A file with all pertinent information has been submitted to the bank for consideration of the loan request. The bank in turn has hired an independent engineer to opine on the client's feasibility study--the architectural and engineering plan and construction budget. This engineering report is included in the loan file and supports the client's data.

6. Bank Loan Practices and Regulatory Prescription

Shopping center construction financing is a type of commercial real estate loan which many banks make. Whether financing land development and/or construction, these loans are very profitable and are extremely attractive to growth-oriented banks. However, they can be highly speculative if made against properties that do not generate predictable cash flows, or the underlying assumptions of cash flows do not materialize. Many banks, savings and loans, insurance companies and pension funds have ended up owning (repossessing) real estate credits that do not produce sufficient cash to service extended loans. If market prices are depressed, banks and other lenders keep these loans on their books to avoid taking losses.

Construction loans are generally short term loans and represent interim financing until permanent (long term) financing is arranged in the form of a mortgage from a bank, insurance company or a pension fund. Construction loan maturities may be extended when developers cannot find permanent financing. A bank extending a construction loan to a builder disburses the funds on a monthly basis, based on actual contractor bills presented to the banker and subject to inspection verification.

The higher rates of return and commensurate risks associated with construction loans have prompted US bank regulators to introduce uniform standards for real estate lending activities. One such regulator, the Office of the Comptroller of the Currency (OCC) which oversees the activities of federally-chartered banks, requires national banks (such as Hellenic National Bank) to adopt written real estate lending policies that are consistent with safe and sound banking practices and are appropriate to the size of the bank and the nature and scope of its operations. A representative set of OCC pronouncements is identified below under appropriate headings.

6.1. Commercial Construction Lending Risks

With construction loans vulnerable to a wide variety of risks, a bank must properly assess the developer's expertise and financial strength to complete the construction project within specified cost and time limits. When evaluating the likelihood that a proposed construction project will be successful, a bank should be aware of the following risks:

- Failure to complete the project by the agreed take-out date voids a commitment for permanent financing.
- Cost overruns occur and may exceed the take-out commitment (permanent financing arrangement) or the sale price of the completed project.

- For example, inclement weather, material or labor shortages, or substandard work that must be redone to pass inspection can delay completion, increase interest expense, and cause the total cost of the project to exceed the original budget.
- Completed project is an economic failure.
- Progress payments diverted by developer prompting suppliers and subcontractors to file mechanics liens for non-payment of debts.
- General contractor files for bankruptcy before completing the project.
- Labor disputes or the failure of a major supplier or subcontractor to deliver goods and services.
- Uninsured destruction of completed work or work in process.

6.2. Underwriting Standards

Prudently underwritten real estate loans should reflect all relevant credit factors, including:

- The capacity of the borrower, or income from the underlying property, to adequately service principal and interest on the debt. This can be measured through the "debt service coverage" ratio (number of times net operating income will cover annual debt service). While minimum ratio requirements will vary between banks and by type of project, they usually fall within the range of 1.05 to 1.5.
- The value of the mortgaged property.
- The overall creditworthiness of the borrower including the demands of supporting other projects.
- The level of equity invested in the property by the borrower.
- Any secondary sources of repayment.
- Any additional collateral or credit enhancements, such as mortgage insurance, take-out commitments, or guarantees. In the latter case the bank should obtain information on the guarantor's financial condition and capacity to fulfill the obligation if the borrower defaults on the loan.
- Extension of credit should be consistent with the bank's internal loan-to-value (LTV) limits and should not exceed supervisory limits for the specific real estate category.

6.3. Evaluating the Collateral

Real estate loans are made with a reasonable probability that the borrower will have sufficient cash flow to meet the repayment terms. However, with the value of the collateral a significant factor affecting lending risk, it is essential for the bank to rely on an independent and objective valuation of the real estate collateral. This valuation would assure the bank that the completed project will provide adequate collateral coverage of the loan. To this end the bank should, at a minimum, obtain an "as is" appraisal of the market value of the property. Banks also normally request that the appraiser report the "as completed" value of the project when a stabilized level of occupancy is achieved. When reviewing the reasonableness of the facts and assumptions associated with the value of the collateral, the lending institution may take into account such considerations as:

- Current and projected vacancy and absorption rates.
- Lease renewal trends and anticipated rents.
- Volume and trends in past due leases.
- Effective rental rates or sale prices.
- Net operating income of the property as compared with budget projections.
- Discount rates (net present value of the future net operating income stream) and direct capitalization rates (how fast an investment will pay for itself)

6.4. Warning Signs for Problem Real Estate Loans

A number of early warning signs, such as delinquency in the payment of interest, could indicate potential problems with individual real estate construction loans. Other warning signs could include:

- An excess of similar projects under construction or completed and not leased/sold.
- A pattern of increasing marketing periods or increasing concessions and declining effective rents for similar projects.
- Construction delays or other events that could lead to cost overruns that may require renegotiation of loan terms.
- A feasibility study or analysis that fails to reflect current and reasonably anticipated market conditions
- Subsequent changes to the initial concept or plan of construction (e.g., because of unfavorable market conditions).
- Other indications of potential or actual difficulties in a bank's commercial real estate portfolio may include:
- Rent concessions or sales discounts that cause the borrower to have less cash flow than projected in the original feasibility study or appraisal.
- Unusually generous concessions on tenant space, moving expenses, and lease buyouts.
- Slow leasing, the lack of sustained sales activity, or sales cancellations that could reduce a project's income potential, thereby leading to protracted repayment or default on the loan.
- Delinquent lease payments from major tenants.

7. Credit Guidelines

With all the pertinent information in the client's file, George must decide on the merit of the loan request. To make up his mind on whether or not to recommend the credit to the bank's loan committee, he thought appropriate to review the strengths and weaknesses of the request, highlight the critical issues, and develop the reasoning behind his decision.

Your assignment is to address the following issues:

1. Identify at least three positives and three negatives about the Garda loan request (present these points in the form of bullet statements or phrases)
2. Discuss the major issues associated with the loan request
3. Determine whether or not the bank should make the loan and discuss the reasoning behind your recommendation (select only one of the two alternatives below)
   - If you decide in favor of the loan, clarify whether you would extend both construction and development financing, or just construction given the availability of permanent financing from a third party. Further, identify any terms or conditions you deem appropriate to safeguard the bank's claim.
   - If, on the other hand, you decide against the loan, on what grounds would you turn down the request?
4. If the loan were to be made, could the company lock in the cost of financing by hedging against interest rate risk?

Table 1

Tenants, Lease Commitments, and Rates

	Date Lease			Annual Rate
Tenant s	Begins	Ends	Sq. Ft.	$ Rent/SF*
Burger King	10/5/2012	10/4/2032	5,520	$31.50
Marfin Laiki Bank	10/4/2012	10/3/2022	2,050	$36.54
Furniture store	10/3/2012	10/2/2019	4,006	$31.95
Arts and Craft	10/6/2012	10/5/2017	1,055	$31.85
Jewelry	10/9/2012	10/8/2017	2,333	$31.00
Dry Cleaning	10/8/2012	10/7/2017	1,650	$30.00
Beauty Salon	10/2/2012	3/1/2018	1,960	$28.00
Optical accessories	10/13/2012	10/12/2017	1,995	$22.00
Clothing/Footwear	10/22/2012	2/1/2019	8,000	$15.00
3 Vacant	n.a.	n.a.	4,642	--

*Converted at current dollar exchange rates

Note: The rental rate for the Clothing/Footwear tenant will increase to $20/sf in 2013 and $26 thereafter.

Source: Author's analysis.

Table 2

Proforma Income and Expense Analysis, 2013-2014

	Lease		Annual Rate	2013	2013	2014
Tenants	Expiration	Sq. Ft.	$ Rent/SF	Income/Mo	Annual Amount	Annual Amount
Burger King	10/4/2032	5,520	$31.50	$14,490.00	$173,880	$173,880
Marfin Laiki	10/3/2022	2,050	$36.5443	$6,243.00	$74,916	$74,916
Furniture store	10/2/2019	4,006	$31.95	$10,667.67	$128,000	$128,000
Arts and Craft	10/5/2017	1,055	$31.85	$2,800.00	$33,600	$33,600
Jewelry	10/8/2017	2,333	$31.00	$6,026.92	$72,323	$72,323
Dry Cleaning	10/7/2017	1,650	$30.00	$4,125.00	$49,500	$49,500
Beauty Salon	3/1/2018	1,960	$28.00	$4,573.33	$54,880	$54,880
Optical	10/12/2017	1,995	$22.00	$3,657.50	$43,890	$43.890
Clothing/Foot	2/1/2019	8,000	$20.00	$13,333.34	160,000	$208,000
Vacant		1,256	$22.00	$2,302.67	$27,632	$27,632
Vacant		1,965	$22.00	$3,602.50	$43,230	$43,230
Vacant		1,421	$22.00	$2,605.17	$31,262	$31,262
Total Rental Revenue				$74,426.08	$893,113	$941,113

Other Income/
Common Area Maintenance Recovery (CAM)*

Furniture store	4,006	$5.00	$20,030	$20,030
Dry Cleaning	1,650	$5.00	$8,250	$8,250
Optical	1,995	$5.00	$9,975	$9,975
Clothing/Foot.	8,000	$4.00	$32,000	$32,000
Other	12,918	$4.00	$51,672	$51,672
Vacant	4,642	$4.00	$18,568	$18,568
Total Revenue & Other Income			$1,033,608	$1,081,608
Less: Market vacancy factor 10%			$103,361	$108,161
Effective Gross Income (EGI)			**$930,247**	**$973,447**

		2013	2014
Expenses	$ Rate per SF	Annual Amount	Annual Amount
Real Estate Taxes	4.81	$159,650	$159,650
Insurance	2.37	78,820	78,820
Management Fee (4% of EGI)	1.08	46,858	48,586
Administration	0.53	17,500	17,500
Repairs & Maintenance	2.67	88,580	88,580
Utilities	0.99	33,024	33,024
Reserves	0.20	6,642	6,642

		2013	2014
Total Expenses	12.65	$431,075	$432,802
Net Operating Income		$499,172	$540,645
Debt Service		$325,692	$325,692
Excess cash flow		$173,480	$214,953

***** Common Area Maintenance (CAM) Recovery--known also as *triple net lease*--represents some or all of the property expenses normally to be paid by the property owner (landlord) passed on to the tenant to pay, in addition to the rent. These include expenses such real estate taxes, insurance, maintenance, repairs and other items predetermined when the lease is signed.
Source: Author's analysis.

Table 3

Key Financial Indicators

Debt Service Coverage ratio (DSCR)		
Net Operating Income/Debt Service	1.53x	1.66x
Project Valuation*		
Net Operating Income: $499,172		
Est. Capitalization Rate: 9.00%		
Estimated Project Value: $5,546,356		

***As per BRE Appraisal Services of Bucharest.**
Source: Author's analysis.

Table 4

Terms and Definitions

Anchor Tenant: A large national or regional retailer that serves as a primary draw for a shopping center; a store strategically located in a retail property in order to enhance, bring attention to, or increase traffic at the property. Sometimes called a "destination" tenant, usually these tenants lease at least 25,000 square feet (sf).
Community Center: A shopping center development that has a total square footage between 100,000-350,000 sf. Generally it will have 2-3 large anchored tenants, but not department store anchors. A Community Center typically offers a wider range of apparel and other soft goods than a Neighborhood Center. Among the more common anchors are supermarkets and super drugstores. Community Center tenants often include retailers selling such items as apparel, home improvement/furnishings, toys, electronics or sporting goods. The center is usually configured as a strip, in a straight line, or an "L" or "U" shape.
Developer: The company, entity or individual that transforms raw land to improved property by use of labor, capital and entrepreneurial efforts.
Freestanding Retail: Single tenant building with a retail tenant. Examples include video stores, and fast food restaurants.
Lifestyle Center: An upscale, specialty retail, main street concept shopping center. An open center, usually without anchors, about 300,000 sf gross leasing area (GLA) or larger, is located near affluent neighbourhoods and includes upscale retail, trendy restaurants and entertainment retail. Nicely landscaped, it offers convenient parking located close to the stores.
Mall: The combined retail center types of Lifestyle Center, Regional Mall and Super Regional Mall.
Neighborhood Center: Provides for the sales of convenience goods (food, drugs, etc.) and personal services (laundry, dry cleaning, etc.) for day-to-day living needs of the immediate neighborhood with a

supermarket being the principal tenant. In theory, the typical GLA is 50,000 sf while in practice it may range from 30,000 to 100,000 sf.
Power Center: The center typically consists of several freestanding (unconnected) anchors and only a minimum amount of small specialty tenants. 250,000-600,000 sf. A Power Center is dominated by several large anchors, including discount department stores, off-price stores, warehouse clubs or "category killers," i.e., stores that offer tremendous selection in a particular merchandise category at low prices.
Shopping Center: The combined retail center types of Community Center, Neighborhood Center and Strip Center.
Strip Center: A strip center is an attached row of stores or service outlets managed as a coherent retail entity, with on-site parking usually located in front of the stores. Open canopies may connect the storefronts, but a strip center does not have enclosed walkways linking the stores. A strip center may be configured in a straight line, or have "L" or "U" shape.
Super Regional Mall: Similar to a regional mall, but because of its larger size, a super regional mall has more anchors, a deeper selection of merchandise, and draws from a larger population base. As with regional malls, the typical configuration is an enclosed mall, frequently with multiple levels (See also: Regional Mall).
Theme/Festival Center: These centers typically employ a unifying theme that is carried out by the individual shops in their architectural design and, to an extent, in their merchandise. Often the biggest appeal of these centers is to tourists, and they can be anchored by restaurants and entertainment facilities. These centers generally located in urban areas, tend to be adapted from older, sometimes historic, buildings, and can be part of mixed-use projects. 80,000-250,000 sf.

Source: CoStar Group Inc., 2010, pp. D-E.

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*** Comptroller of the Currency Administrator of National Banks, "Commercial Real Estate and Construction Lending--Handbook", available at: http://www.occ.treas.gov/handbook/realcon.pdf

*** For an overview on existing malls in Romania see "Shopping Centers and Malls in Romania," available at: http://www.euromonitor.com/Retailing_in_Romania